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IN THE

# Supreme Court of the United States

October Term, 1979

No. ..... 79-1251

HARRIS, KERR, FORSTER AND COMPANY,

*Petitioner,*

*vs.*

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

*Respondents.*

**Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

KIRTLAND & PACKARD,
PHILLIP T. BACKER,
JACQUES E. SOIRET,
626 Wilshire Boulevard, 6th Floor,
Los Angeles, Calif. 90017,
(213) 624-0931,

HORVITZ, GREINES & POSTER,
A Law Corporation,
ELLIS J. HORVITZ,
ALAN G. MARTIN,
15760 Ventura Boulevard, 7th Floor,
Encino, Calif. 91436,
(213) 995-0800,

*Attorneys for Petitioner.*

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

*Respondents.*

**Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

Petitioner, the accounting firm of Harris, Kerr, Forster and Company, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on November 14, 1979.

## OPINION BELOW.

The Opinion of the Court of Appeals, reported at 608 F.2d 377, appears as Appendix A hereto, accompanied by an order of January 3, 1980, modifying the Opinion. No opinion was rendered by the District Court for the Central District of California.

## JURISDICTION.

The judgment of the Court of Appeals for the Ninth Circuit was entered on November 14, 1980. This peti-

tion for certiorari was filed within ninety (90) days of that date, no petition for rehearing having been filed. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

**QUESTIONS PRESENTED.**

1. Whether the scienter requirement of §10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 is satisfied by a standard of "recklessness" which, as construed and applied by the Ninth Circuit Court of Appeals in the present case, sanctions liability for merely negligent conduct?

2. Whether the Ninth Circuit's "flexible duty" approach, as set forth in *White v. Abrams,* which permits the jury to determine both law and fact in federal securities fraud actions may be applied in this case as either a substitute or alternative for scienter requirement enunciated in *Ernst & Ernst v. Hochfelder*?

**STATUTE AND RULE INVOLVED.**

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. §78j(b), provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> "To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as



> necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Commission Rule 10b-5, 17 CFR §240.10b-5, provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> "in connection with the purchase or sale of any security."

**STATEMENT OF THE CASE.**

**A. The Parties to the Transaction.**

Marconsult, Inc., a marine resources consulting firm, was formed in the late 1960's. The firm was consistently cash-poor, and did not prosper. (C.T. 987.) In 1970 new persons assumed management of the company with hopes of changing its fortunes. Despite reorganization and continued investment in research and development the company experienced no sudden turnaround, although management professed to see the beginning of such a turnaround in expected new contracts. (C.T. 532 *et seq.*)

Spectrum Financial Companies, a California corporation ("Spectrum") was general partner of two limited partnerships, Spectrum Leveraged Natural Gas I and II (hereinafter "SLNG I and II") formed in 1970 for the purpose of oil and gas exploration and development. (C.T. 4-5.) Each of ninety-eight high-income individuals (dentists and doctors) invested a minimum of $5,000 for a limited partnership interest in SLNG I or II apparently for the primary purpose of obtaining income tax shelter. (C.T. 74-81.)

**B. The Agreement to Exchange.**

In late 1971, when SLNG I and II held operating oil and gas wells (and therefore no longer served their primary tax purpose), Arnold G. Rudoff, an attorney-CPA and President of Spectrum, commenced negotiations with Marconsult with a view toward an exchange of the partnership interests. The negotiations consummated in a fully-integrated written agreement of January 5, 1972, by which Marconsult agreed to exchange its common stock and convertible promissory notes for the interests of Spectrum and the limited partners in order to improve its traditionally cash-poor situation. (C.T. 544; 953.) While the effective date of the exchange was January 1, 1972, the transaction was conditioned on the qualification of Marconsult securities with the California Commissioner of Corporations and approval of the exchange by 75% of the SLNG I and II voting interests. (C.T. 54-58.)

**C. California Commissioner of Corporations' Approval of Transaction.**

On March 6, 1972, Marconsult filed with the California Commissioner of Corporations an Application



for Permit to issue its common stock and convertible notes as called for in the January 5 contract. On May 16, 1972, the Commissioner's hearing took place and was attended by Mr. Rudoff and an attorney for Spectrum, among others. The financial information submitted by Marconsult showed that for the year ended August 31, 1971, apart from a nonrecurring gain of over $171,000, Marconsult operated at a substantial loss. (C.T. 532.)[1] A statement of income and expenses for the three months ending November 30, 1971, showed a net loss of $27,000. Certain officers of Marconsult, however, expressed their optimism for the future and made certain representations concerning Marconsult's expected revenue and earnings. (*E.g.*, C.T. 542-544.) On June 22, the Commissioner approved the transaction and issued a permit authorizing the exchange on the condition that certificates evidencing ownership of the securities bear a legend prohibiting sale or transfer without prior written consent of the Commissioner. (C.T. 619-622.) The following day Spectrum distributed copies of the permit to the limited partners of SLNG I and II and stated that it intended to proceed with the exchange as to its own interests. (C.T. 648.)

**D. Petitioner's Qualified Opinion of Marconsult's Financial Status.**

On March 8, 1972, Marconsult had retained the accounting firm of Harris, Kerr, Forster and Company ("HKF") to conduct an audit of the 16-month period

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[1]The loss was on the order of $150,000. Including the nonrecurring gain, Marconsult showed a net profit after taxes of but $23,693.92. (C.T. 777.)

from September 1, 1970, to December 31, 1971,[2] and to report on the 12-month calendar year of 1971. (C.T. 999.) During March and April HKF conducted its field work on the audit.

HKF was not requested to, nor did it prepare its audit for use in connection with the exchange (which it first learned of during the audit), was not informed of the May 16 hearing date before the Commissioner of Corporations and did not participate in the hearing, and was not informed that audited financial statements would be submitted to the Commissioner or used in connection with the exchange. (C.T. 438.) Subsequent to the hearing date HKF delivered to Marconsult its qualified opinion letter and accompanying financial statements for calendar year 1971. Marconsult did not furnish this information to anyone outside the company.

In early July, 1972, Marconsult's treasurer requested HKF to issue a report on the 16-month period covered by the audit, and this report was prepared and sent to Marconsult (appearing as Appendix B).[3] The HKF opinion was strongly qualified, reading:

> "Certain investments of the Company and the capitalized development costs, which are further discussed in Notes 2 and 3, represent a significant portion of the total assets of the Company at December 31, 1971. Recovery of the investments and development costs is dependent upon the success of the Company in obtaining future, as well as profitable, projects in these areas.
>
> "In our opinion, subject to the recovery of these costs as described in the preceding paragraph, such financial statements present fairly the financial position of Marconsult, Inc. at December 31, 1971 and the results of their operations for the period then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (Note 1)."

[2]Marconsult had elected to change from an August 31, to December 31 year end. The changeover to a calendar year created a "stub period" of September 1, 1970, to December 31, 1970.

[3]The opinion letter is dated April 24, 1972. This reflects the date field work on the audit was completed, not the date the letter was prepared.



Note 1 informed: "The Company elected to change its reporting period from an August 31 to December 31 year end. Accordingly, the statement of income and accumulated deficit reflects the operations from September 1, 1970 to December 31, 1971. The gross revenue and net loss for the four months ended December 31, 1970 amounted to $294,529 and $(27,340) respectively."

Far from lending itself to the rosy projections of Marconsult management, the financial statements reflected, *inter alia*, current cash at slightly over $5,000, total income for the 16-month period of $351,873 (including the $294,529 of the stub period), accumulated deficit at the beginning of the period of $73,453 and accumulated deficit at the end of $346,397.

### E. Limited Partners' Approval of Transaction Without Reliance on 16-Month Report.

By July 10, 1972, the requisite 75% approval of the SLNG I and II limited partners was obtained. (C.T. 596-603.) None of the accepting limited partners had seen the 16-month report. The actual exchange of interests took place in October, 1972. In the interim, Marconsult applied for removal of the restrictive legend

on its securities required by the June 22 permit. (C.T. 1074.) Notwithstanding the precarious financial condition of Marconsult as shown in the 16-month report, which was submitted with the application and confirmed the unaudited financial statements previously submitted, the legend condition was removed. (C.T. 1077.)

**F. The Lawsuit.**

Marconsult continued its operations, acquiring the George F. Casey Company in early 1973. Later that year, however, it became apparent that the company's earlier revenue and income projections were seriously wide of the mark. Thereafter Marconsult entered bankruptcy.

Spectrum was quick to charge fraud. In the operative fourth amended complaint, Spectrum accused Marconsult and its officers, the accountant who had prepared Marconsult's 1969 and 1970 audits, and HKF, along with others of (1) violation of federal securities laws, (2) violation of state securities laws, (3) fraud, and (4) money lent and received. Six of the SLNG I and II limited partners intervened in the action. When their motion for certification of a class action was denied, other limited partners were urged to, and fifty-six of them did, file a separate action (the "Barbieri action"), with a complaint identical to that of Spectrum. The actions were consolidated. Jurisdiction of the District Court was invoked under 15 U.S.C. sections 77v and 78aa.

As against HKF, the various complaints charged that HKF had committed material misrepresentations or omissions in the 16-month report or had somehow aided and abetted Marconsult's alleged misrepresentations or omissions. Essentially, it was alleged that the 16-month report failed to sufficiently call attention to the precarious financial condition of Marconsult.



**G. Motion for Summary Judgment.**

Following extensive discovery by all parties, in late 1975 HKF unsuccessfully moved for summary judgment against the intervenors in the Spectrum action on the ground they had not relied on the HKF report in agreeing to the exchange. The motion was denied. A few months later this Court's decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976) was released, and HKF moved for summary judgment based on the principles of that case. Because the complainants raised no triable issue of fact regarding scienter as required in *Hochfelder,* summary judgment was granted and the actions dismissed as to HKF.

**H. The Judgment and Opinion of the Court of Appeals.**

The Ninth Circuit Court of Appeals reversed the grant of summary judgment and remanded for reconsideration in light of its decision in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir. 1978), cert. den. 439 U.S. 970, which established a "knowing or reckless" standard for scienter.

Further, the Court inferred from the denial of the first motion for summary judgment that the District Court concluded there were genuine issues of material fact under the then-prevailing "flexible duty" analysis of *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974), but not under *Ernst & Ernst v. Hochfelder* which disapproved *White v. Abrams.* Over the objection of one member, who correctly identified the flexible duty test as a negligence test, the Court expressly resurrected the flexible duty test, and, apparently as an alternative basis for decision, held summary judgment inappropriate because it found a triable issue of fact under that test.

## REASONS FOR GRANTING THE WRIT.

### I

### THE OPINION OF THE COURT OF APPEALS CONFLICTS WITH THE LANGUAGE AND PURPOSE OF SECTION 10(b) AS CONSTRUED IN ERNST & ERNST v. HOCHFELDER.

#### A. Actions Under Section 10(b) and Rule 10b-5 Must Be Supported by Allegations and Proof of Defendant's Intent to Deceive, Manipulate or Defraud. As a General Rule, Recklessness Alone Cannot Suffice.

In *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185, this Court held that a private cause of action for damages will not lie under §10(b) and Rule 10b-5 in the absence of an allegation of scienter. The plain terms[4] of §10(b) dictated both the holding and the Court's definition of scienter—"intent to deceive, manipulate, or defraud." (*Id.* at 193.)

Because "[t]he language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception" (*Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473 (1977)), negligence cannot give rise to liability under §10(b) and Rule 10b-5. For the same reason, recklessness should not give rise to liability. First, it is difficult to imagine how one who recklessly misstates or omits to state facts could possibly be said to have done so as a "manipulative or deceptive device or contrivance." When it is also recalled that the statute refers to the use or employment of such a device or contriv-

[4]"The starting point in every case involving construction of a statute is the language itself." (*Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 756 (Powell, J., concurring) (1975).)



ance, it should follow that recklessness does not fall within the scope of the statute. "To use or employ" is the language of intentionality.[5] These are goal-directed terms meaning "to utilize toward some end." (See *Webster's New International Dictionary* (2d ed. 1934).) Recklessness is the very antithesis of goal-directed conduct since it is conduct heedless of its consequences. (*Ibid.*)[6]

However, in *Hochfelder* this Court left open the question whether, in some circumstances, recklessness could satisfy the scienter requirement: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5." (*Id.* at p. 193, n. 12.) As the instant case illustrates, this open question has been exploited by the lower courts, especially the Ninth Circuit, to carve an exception as broad as the *Hochfelder* rule. Despite "the language of §10(b) which so clearly connotes intentional misconduct" (*Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185, 201) a general recklessness (*i.e.,* non-intentional) standard now prevails.

[5]In *Hochfelder,* footnote 20, this is suggested without amplification.

[6]The inappropriateness of a general recklessness standard is, perhaps, most readily seen when a defendant is charged, as is Petitioner (at least in part), with having aided and abetted in the commission of a §10(b) violation. What, precisely, can it mean to say someone recklessly aided and abetted someone else? And what if the liability of the person who was aided and abetted was in turn based only on recklessness?

**B. The Lower Courts and Especially the Ninth Circuit in the Instant Case Have Adopted a General Recklessness Standard Which Vitiates Hochfelder.**

The eye of the needle in *Hochfelder's* footnote 12 now readily accommodates camels of all sizes, so long as they are labelled "recklessness."

This trend apparently began when the lower federal courts started to read footnote 12, to the exclusion of the rest of the opinion, as though it said "we need not address here the question whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5," omitting to note that the narrow question the Court left open was whether "*in some circumstances*" recklessness might be sufficient. With footnote 12 thus distended and *Hochfelder* thus distorted, the lower courts began accepting recklessness as adequate scienter in *all* circumstances in §10(b) actions. (See, *e.g., Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1023-1024 (6th Cir. 1979); *Nelson v. Serwold, supra,* 576 F.2d 1332, 1337; *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 44 (2d Cir. 1978), cert. den. 439 U.S. 1039;[7] *Coleco Industries Inc. v. Berman,* 567 F.2d 569, 574 (3rd Cir. 1977), cert. den. 439 U.S. 830; *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), cert. den. 435 U.S. 952; *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir. 1977), cert. den. 434 U.S. 875.) Few courts have even acknowledged that the adoption of a general recklessness standard threatened re-introduction of the negligence approach rejected in *Hochfelder.* (See *Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977).)[8]

[7]By its terms *Rolf* endorsed the recklessness standard only in cases involving a defendant who owed a fiduciary duty to the plaintiff. For another illustration of this "sliding scale" approach to scienter see *Edward & Hanly v. Wells Fargo Securities, Etc.,* 602 F.2d 478 (2d Cir. 1979).



These cases focus on footnote 12 of *Hochfelder* and proceed by parsing and teasing the rest of the opinion to reach results precisely contrary to the holding of the case. *Nelson v. Serwold, supra,* 576 F.2d 1332, the Ninth Circuit's first recklessness ("knowing or reckless") case, perhaps summarizes the results of this process. There the court declared that *Hochfelder's* "terminology, analysis and citation to authority . . . lend credence to a broad interpretation of scienter" and concluded "*Ernst & Ernst*, we think, only went so far as to eliminate negligence as a basis for liability." (*Id.* at p. 1337.)

Nowhere in these cases does one find any consideration of the terms of §10(b) which should have been the starting point of inquiry. Thus, in some courts

[8]It seems some courts attempted to define "recklessness" in ostensibly stringent fashion to partially comport with *Hochfelder.* (*E.g., Franke v. Midwestern Oklahoma Development Authority,* 428 F.Supp. 719, 725 (W.D. Okl. 1976).) Subsequently, all but the merest pretense of complying with *Hochfelder* disappeared. For example, in *Rolf v. Blyth, Eastman Dillon & Co., Inc., supra,* 570 F.2d 38, the majority "patche[d] together watered-down notions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed by the Supreme Court in *Ernst & Ernst v. Hochfelder*" (*id.* at 50, Mansfield, J., dissenting). In *Mansbach v. Prescott, Ball & Turben, supra,* 598 F.2d 1017. 1025, the court expressly purported to limit *Hochfelder*: "We believe that *Hochfelder* should be read to go no further than its specific holding that mere negligence is not enough for liability." And in the instant case the Ninth Circuit readopted the "flexible duty" test of *White v. Abrams, supra,* 495 F.2d 724, which was identified in footnote 12 of *Hochfelder* as one of the cases overruled by that case, as the Ninth Circuit itself previously recognized in *Ritzau v. Warm Springs West,* 589 F.2d 1370, 1374 (9th Cir. 1979). As Judge Ferguson observed in this case (Appendix A, p. 18): "[T]he flexible duty negligence standard is just that—a negligence standard."

plaintiff need only allege that a defendant "should have known" certain facts (see *Stern v. American Bankshares Corp.*, 429 F.Supp. 818, 827 (E.D. Wisc. 1977)); he may have the jury instructed that recklessness means "carelessness approaching indifference" (*Hoffman v. Estabrook & Co., Inc.*, 587 F.2d 509, 516 (1st Cir. 1978)),[9] and he may satisfy the scienter burden of proof upon showing that defendants "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary efforts." (*Kiernan v. Homeland, Inc.*, .... F.2d .... (9th Cir. 76-1454, filed January 15, 1980).)

If *Hochfelder* is to remain law in fact, not just in name, it must be revitalized. The present case raises the issue squarely and provides an appropriate vehicle for such revitalization.

### C. There Is No Definition of Recklessness Consistent With Hochfelder Under Which Petitioner May Be Held Liable to Respondents.

Even if, in some possibly conceivable circumstances, recklessness might be sufficient scienter for liability under §10(b) and Rule 10b-5, the definition of recklessness cannot, consistent with *Hochfelder,* be stretched so far as to sweep in Petitioner under the alleged facts of this case. As found by the District

[9]As appears from these cases, the appellate courts have for the most part either refrained from defining "recklessness" (see *Mansbach v. Prescott, Ball & Turben, supra,* 598 F.2d 1017, 1025; and see Appendix A, page 14) or done so in either impossibly vague terms or terms which bear strong resemblance to ordinary negligence. In either case, the question is effectively left entirely to the fact-finder to settle under whatever personal construction may be made of the law.



Court, the complainants in this action, despite numerous opportunities to do so, failed to allege or show that Petitioner intended to deceive, manipulate, or defraud Spectrum or the limited partners of SLNG I and II. The most they showed was that Petitioner, while fully and fairly describing (for Marconsult) Marconsult's precarious financial condition, did not believe the facts warranted a conclusion that Marconsult was not a going concern; in other words, they showed only arguable negligence.

If recklessness can ever satisfy the scienter requirement, surely such recklessness must be at least the functional equivalent of intent. (See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968), Friendly, J., concurring (en banc), cert. den. sub nom. *Coates v. SEC,* 394 U.S. 976.) If functional equivalence of intent is the proper test, then the District Court's determination that the action could not proceed for lack of the element of scienter must be taken to foreclose consideration under a recklessness standard because there is no evdence of any conduct by Petitioner, reckless or otherwise, which meets this test. Indeed, it is difficult to pinpoint what precisely Petitioner is charged with doing recklessly. It was retained to audit a 16-month period. As requested, it prepared a report on the 12-month calendar year and then on the entire audited period. The 16-month financial statement fairly reflected Marconsult's precarious financial condition; the qualified opinion letter called attention to the fact that a large proportion of Marconsult's assets were of a speculative nature; Note 1 of the financial statements (referenced in the opinion letter) showed that for calendar year 1971

Marconsult had very little income and had suffered a substantial loss.

This was the same story shown in the financial statements submitted to the Commissioner of Corporations who remarked on Marconsult's dubious financial picture. Indeed, Marconsult had shown a profit in only one year of its five-year existence. (C.T. 987.) Counsel for Spectrum admitted that Marconsult's income for the preceding two years had not been "anything to write home about" (C.T. 558) but still argued in favor of the exchange.

Petitioner fairly set forth the financial condition of Marconsult for the 16-month period it had audited; surely it could not be expected to know whether Marconsult's new management was in a position to make the turnaround they hoped for. Yet the Court of Appeals apparently agreed with Respondents that Petitioner could be found to have acted recklessly by failing to state that Marconsult was not a going concern—when it had been a going concern on essentially the same footing for years and continued as a going concern for more than a year afterwards. If Petitioner could be found liable on this basis, any judgment call could be considered reckless as long as plaintiffs can find an expert who says he would have called it another way.[10]

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[10]In this case, for example, Respondents found someone who apparently would testify that in his opinion Petitioner did not act in accordance with generally accepted accounting principles. There is no indication he could or would testify to anything more than negligence. On the other hand, Petitioner was prepared to produce senior members from two of the "Big Eight" accounting firms and an Associate Dean from the UCLA Graduate School of Business to testify that the 16-month financial statements were prepared in conformity with generally accepted accounting principles and that the qualified opinion letter was proper in the circumstances.



Reconsideration of the summary judgment for Petitioner is merely an invitation to the trial court to construe alleged negligence as recklessness as scienter.

Petitioner respectfully submits that the time has arrived for this Court to reaffirm the plain meaning of *Hochfelder*, by granting this petition and reversing the judgment of the Court of Appeals or, if this Court wishes to reconsider its decision in *Hochfelder*, to do so now and end the continuing confusion and inconsistency current in this important and active area of the law.

## II

## THE FLEXIBLE DUTY APPROACH ADOPTED IN THE DECISION BELOW CONFLICTS IN PRINCIPLE WITH THE DECISIONS OF THIS COURT. IT IS A SHIFTING AND HIGHLY FACT-ORIENTED ANALYSIS WHICH PREVENTS UNIFORM ENFORCEMENT OF FEDERAL SECURITIES LAWS.

### A. White v. Abrams Was Overruled by Ernst & Ernst v. Hochfelder.

In *White v. Abrams, supra,* 495 F.2d 724, the Ninth Circuit Court of Appeals purported to redefine the elements of a §10(b) and Rule 10b-5 action, stating (at pp. 734-735): "[W]e reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that Rule 10b-5 imposes on this particular defendant." The Court explained this flexible duty approach as follows (at pp. 735-736):

> "Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defend-

ant's duty under Rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question." (Footnotes omitted.)

In *Hochfelder,* footnote 12, page 193, *White v. Abrams* and its flexible duty analysis were expressly identified as antithetical to the holding of the case. The Ninth Circuit itself has inconsistently recognized and denied the continued viability of *White v. Abrams.* For example, in *Crocker Citizens National Bank v. Control Metals Corp.,* 566 F.2d 631, 632, n. 2 (9th Cir. 1977), the court asserted that "[a]bsent the possibility of liability based upon negligence, *Hochfelder* is not inconsistent, on its facts, with the flexible duty standard established in *White v. Abrams.*" But in *Ritzau v. Warm Springs West, supra,* 589 F.2d 1370, 1374, the court admitted that *Hochfelder* had "explicitly rejected" the flexible duty approach. Nevertheless, in *Zweig v. Hearst,* 594 F.2d 1261, 1268, n. 13 (9th Cir. 1979) and in the instant case *White v. Abrams* has been resurrected, Phoenix-like, from the ashes of *Hochfelder.*

As Judge Ferguson said (Appendix A, p. 18): "[T]he flexible duty negligence standard is just that—a negligence standard." If the instant decision escapes review, this negligence standard is once again, *Hochfelder* notwithstanding, the law of the Ninth Circuit.



**B. As Illustrated by Its Application to Petitioner, the Flexible Duty Approach Leaves It to the Jury to Decide Both Fact and Law in a Manner Completely Inconsistent With the Dictates of Federal Securities Laws.**

The flexible duty approach is, by its terms, a scienter substitute. It attempts to bring the entire range of common law fraud plus breach of fiduciary duties within the ambit of §10(b) actions. (*Cf., Santa Fe Industries, Inc. v. Green, supra,* 430 U.S. 462.) This approach essentially enables the jury to determine the law as well as the facts. (A. Bromberg, *Securities Law, Fraud-SEC Rule 10b-5,* §8.5 (1975).) Its potential for confusion in enforcement of federal securities law has been noted. (*Dupuy v. Dupuy,* 551 F.2d 1015 (5th Cir. 1977), cert. den. 434 U.S. 911.) In virtually every case it mandates "a shifting and highly fact-oriented" disposition of the issue of who may bring a damages claim for violation of §10(b) against whom and on what basis. (See *Blue Chip Stamps v. Manor Drug Stores, supra,* 421 U.S. 723, 755.) Even worse, "[a] jury verdict will be hard to overturn for insufficiency of evidence since the specific facts giving rise to the duty will probably be unidentifiable." (A. Bromberg, *op. cit., supra,* §8.5.) Whatever lip service is paid *Hochfelder,* the flexible duty approach leaves it to the jury to determine the operative elements of §10(b) and Rule 10b-5 actions, at the same time making such determination essentially unreviewable.

The Court of Appeals' illustration of how the flexible duty approach applies to Petitioner in this case exemplifies the broad reach of this analysis, as either a substitute or alternative for scienter.

Of the five basic elements of the flexible duty approach, the Court of Appeals purported to apply four to Petitioner, acknowledging that "defendant's initiation of the transaction" was inapplicable. Considering the remaining four elements the Court found:

(a) Relationship of Plaintiff to Defendant—"Indirect"; supposedly Petitioner had "strong incentive" to make Marconsult look good on paper to assure payment of its fee, therefore also satisfying element (3), benefit to defendant.[11]

But by any reasonable measure there was simply no relationship between Petitioner and Respondents. As Judge Ferguson said (Appendix A, p. 18): "There is no real relationship between plaintiff and defendant here . . . thus the Court is confronted with the necessity of manufacturing the relationship. . . ."

(b) Defendant's access to information—"It goes without saying that an accountant has greater access to a company's financial data than a potential purchaser." The point is irrelevant.[12] The 16-month financial statement fully discloses Marconsult's financial condition; it reflects the change from fiscal to calendar year accounting periods; it separately states income and loss for the stub period; the opinion letter reveals the questionable nature of the bulk of Marconsult's assets. Respondents really claim that on the facts as

[11]The only reference in the record to Petitioner's fee for the Marconsult audit is that it was to be approximately $2,500.

[12]Respondents could have used the subpoena power of the Commissioner of Corporations to obtain any information they needed. The Court's statement that "they would not have obtained the data as easily as could HKF, nor would they be as skilled in interpreting the raw data" is completely conjectural and presumes, contrary to the record, that Respondents were unassisted in their investment decisions.



shown Petitioner should have adjudged Marconsult not to be a going concern. Whether Petitioner should or should not have done so involved judgment not further information.

(c) Defendant's awareness of Plaintiff's reliance—"If appellants relied on HKF's statement, it is logical to conclude that appellants relied on HKF, and that HKF knew of this reliance."

First, the Court itself noted in its statement of facts that "Spectrum received the requisite 75% approval on July 10. None of the accepting limited partners had seen any of Marconsult's financial statements, and the 16-month report had not been disseminated outside Marconsult as of that date." Second, while Petitioner knew that the exchange was conditioned upon approval of the Commissioner of Corporations, this approval was given on June 22, before the 16-month report was prepared. The acceptance by Spectrum and the SLNG I and II limited partners was made following issuance of the permit with the restrictive legend condition.[13] Accordingly, it is neither logical nor permissible to conclude either that Respondents relied on any statement of Petitioner, or if there had been such reliance, that Petitioner could have known of it.

On the basis of this analysis the court concluded that there was a triable issue of fact whether Petitioner owed Respondents any duty. Summary judgment was therefore held inappropriate, despite the fact summary

[13]Respondents have contended that the exchange contemplated free transferability of Marconsult stock. The written agreement, however, contains no such condition and states that it "contains the entire agreement between the parties." In any event, there is no suggestion that Petitioner was aware of any terms of the agreement not reduced to writing.

judgment had been granted because Respondents failed to raise any triable issue of fact regarding scienter.

As the present case illustrates, the flexible duty approach is so flexible it creates the potential for unforeseen and essentially unlimited liability, particularly on the part of the accounting profession. That the "overall impact of *Abrams* is to extend the range of liability in individual Section 10(b) actions" (*In re U.S. Financial Securities Litigation*, 64 F.R.D. 443, 453 (S.D. Cal. 1974)) could not be more forcefully brought home by its employment in this case.

The flexible duty approach has no place in §10(b) actions either as a substitute for or as an alternative to the scienter requirement as explained in *Hochfelder*. Petitioner respectfully submits that the previous decisions of this Court and the uniform application of the federal securities laws call for the granting of the instant petition and reversal of the decision below.

**CONCLUSION.**

*Ernst & Ernst v. Hochfelder* introduced sorely-needed clarification and certainty to actions under §10(b) and Rule 10b-5, holding scienter, *i.e.*, intent to deceive, manipulate or defraud, to be a *sine qua non* of such actions. In just a few years, however, pre-*Hochfelder* confusion and inconsistency has reappeared and any meaningful definition of scienter has given way to "recklessness" and "flexible duty" which both theoretically and as applied in this case impose liability for negligence.

In enacting §10(b), Congress spoke concisely and plainly; it did not create a private right of action under the statute. So long as this Court sanctions the *judicially-created* private right of action under §10(b)



and Rule 10b-5, it must, in fairness, act as regular arbiter of the scope of such proceedings. It is, therefore, essential that this Court again address this issue to assure that the ever-expanding scope of §10(b) and Rule 10b-5 actions remains true to Congressional purposes.

Accordingly, Petitioner respectfully submits that if *Hochfelder* is to be law, as it should, it requires reaffirmation and revitalization through reversal of the decision in this case.

Respectfully submitted,

KIRTLAND & PACKARD,
PHILLIP T. BACKER,
JACQUES E. SOIRET,

HORVITZ, GREINES & POSTER,
A Law Corporation,
ELLIS J. HORVITZ,
ALAN G. MARTIN,
*Attorneys for Petitioner.*

## APPENDIX A.

### Order.

United States Court of Appeals for the Ninth Circuit.

Spectrum Financial Companies, Plaintiff-Appellant, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees.

Allen L. Barbieri, et al., Plaintiffs-Appellants, James E. Nevitt, Intervenor-Appellant, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2546. DC No. CV 74-3458-R and CV 75-2466-R, (Manuel Real) Central District of CA.

Spectrum Financial Companies, Plaintiff, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2651, DC No. CV 75-2466-R.

Filed Jan. 3, 1980.

Before: Wright and Ferguson, Circuit Judges; and Hoffman,* District Judge.

The opinion filed on November 14, 1979 is hereby amended as follows:

On page 5, line 7, the word "pleadings" is deleted.

On page 6, line 26, the words "pleadings and" are deleted.

On page 7, lines 6-8, the clause is corrected to read, "*this court delimited the duty owed by a given defendant to a given plaintiff.*"

**Opinion.**

In the United States Court of Appeals for the Ninth Circuit.

Spectrum Financial Companies, Plaintiff-Appellant, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al., Defendants-Appellees. No. 76-2546.

Allen L. Barbieri, et al., Plaintiffs-Appellants, James E. Nevitt, Intervenor-Appellant, v. Marconsult, Inc., et al., Defendants-Appellees. Spectrum Financial Companies, Plaintiff, Kenneth B. Bonilla, et al., Intervenors-Appellants, v. Marconsult, Inc., et al. Defendants-Appellees. No. 76-2651.

Filed Nov. 14, 1979.

Appeal from the United States District Court
for the Central District of California

Before: WRIGHT, Circuit Judge; HOFFMAN, Senior District Judge;* and FERGUSON, District Judge.**

WRIGHT, Circuit Judge:

Spectrum Financial Companies, the general partner of two limited partnerships, sued under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1976), and § 17(a) of the Securities Exchange Act of 1933, 15 U.S.C. § 77g (1976), alleging that Marconsult, Inc. and its accounting firm, Harris, Kerr, Forster and Company (HFK), made false and misleading statements regarding the value of Marconsult stock which Spectrum's limited partners received in exchange for oil and gas leases. Several limited partners intervened.

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*Of the Eastern District of Virginia.

**Of the Central District of California.



The district court refused to certify as a class Spectrum and its limited partners and granted HKF's motion for summary judgment.

We affirm the denial of class certification and reverse the grant of summary judgment. The case is remanded for reconsideration in light of *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978).

FACTS

In January, 1972, Spectrum entered into an agreement with Marconsult. The limited partners agreed to exchange their interests in oil and gas wells for common stock and debentures of Marconsult. The agreement was conditioned upon qualification of the securities with the California Commissioner of Corporations and upon approval of the exchange by 75% of the limited partners.

In March, 1972, Marconsult applied to the Commissioner for a permit to issue its common stock and convertible notes to Spectrum. Two days later, Marconsult hired HFK to audit its financial condition and render an opinion for the 1971 calendar year.

On May 8, HKF delivered to Marconsult draft copies of a financial statement for the calendar year 1971, together with its audit report dated April 24, 1972. The 12-month statement was unfavorable, disclosing that Marconsult had but $57,000 in sales and had suffered a loss of almost $250,000 during the year.

The Commissioner's hearing took place on May 16. Marconsult did not distribute the financial statement to Spectrum and the limited partners or submit it for the consideration of the Department. Following the hearing, the Deputy Commissioner indicated that

the application stood submitted pending the filing of additional financial data. HKF delivered to Marconsult its opening letter, with financial statements, on May 24.

The report was furnished to no one outside Marconsult. Instead, the company requested HKF to prepare and certify new financial statements covering a 16-month period from August 31, 1970 to the end of 1971.

Meanwhile, despite the fact that no additional financial data were submitted to the Department, the permit to issue securities was granted on June 22. It contained a legend severely restricting the transfer of the securities in the limited partners' hands.

HKF delivered the 16-month financial statement to Marconsult in early July. It incorporated more than $200,000 of business conducted during the four months before the beginning of the 1971 calendar year. As a result, it was considerably more favorable than the 12-month report. HKF's new opinion letter followed on July 18.

Spectrum received the requisite 75% approval on July 10. None of the accepting limited partners had seen any of Marconsult's financial statements, and the 16-month report had not been disseminated outside Marconsult as of that date. On August 17, nevertheless, Marconsult applied to the Commissioner for an order removing the restriction on transfer, and the 16-month statement was submitted as part of the application. The Commissioner removed the restriction.

The exchange took place in October 1972. In July 1973, it was apparent that Marconsult had fallen dras-



tically short of its income projections and was virtually insolvent.

Spectrum filed suit, alleging that Marconsult and HKF violated federal securities laws by failing to disclose the shaky foundation of Marconsult's stock. Spectrum's limited partners moved for an order certifying them as a class. The motion was denied as was a motion for interlocutory appeal. Fifty-six of the 92 nonparty limited partners then filed a new action, and the two actions were consolidated for trial.

HKF moved unsuccessfully for summary judgment in December 1975. In March 1976, the Supreme Court decided *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). HKF renewed its motion on the basis of the scienter requirement of that case and this time summary judgment was granted.

## SUMMARY JUDGMENT

Summary judgment is appropriate only where there is no genuine issue as to any material fact. Fed. R. Civ. Proc. 56; *Lane Bryant v. Maternity Lane,* 173 F.2d 559, 565 (9th Cir. 1949). All inferences that can be drawn from the pleadings, depositions, admissions, and affidavits on file must be viewed in a light most favorable to the party opposing summary judgment. *United States v. Diebold, Inc.,* 369 U.S. 654 (1962).

A genuine issue must be predicated on a viable legal theory. *McGuire v. Columbia Broadcasting System, Inc.,* 399 F.2d 902, 905 (9th Cir. 1968). In this circuit, prior to *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), scienter was not a necessary predicate for liability under § 10(b) and Rule 10b-5. *See, e.g., White v. Abrams,* 495 F.2d 724, 734-

35 (9th Cir. 1974). We applied a "flexible duty" standard incorporating many factors to determine whether the defendants had a duty to disclose information relevant to the purchase or sale of securities. *Id.*

The district court denied summary judgment under the applicable Ninth Circuit standard, but granted it after *Hochfelder* clearly established that scienter is an element of Rule 10b-5 violations. Because this change in the applicable legal standard was the only event intervening between the denial and grant of summary judgment, we must assume that the trial court believed there were genuine issues of material fact under the old standard but that appellants failed to establish a genuine issue with respect to scienter.

*Scienter*

Appellants argue that the trial court erred in interpreting too strictly the scienter requirement. They contend that the element of scienter may be established by proof of reckless behavior, and that the pleadings and depositions on file raise a genuine issue of material fact as to whether HKF acted recklessly in supplying Marconsult with the 16-month statement.

In *Hochfelder,* the Court reserved the question whether "reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 425 U.S. at 193-94 n.12. This court answered the question affirmatively in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978).

*Nelson* contains a thorough discussion of the scienter requirement and the effect of *Hochfelder.* We concluded that "recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate



and cold-blooded' " would support liability under § 10(b) and Rule 10b-5. *Nelson v. Serwold,* 576 F.2d at 1338. Our holding is in accord with those of other circuits. *See, e.g., Edward J. Mawod & Co. v. Securities & Exch. Co'mn,* 591 F.2d 588, 596 (10th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 46 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

The district judge did not have the benefit of our decision in *Nelson* when he granted summary judgment. He did not indicate whether he examined the pleadings and depositions in light of a recklessness standard or required some stricter showing of intent. We believe that he should have the opportunity to determine, in the first instance, whether appellants have raised a genuine issue of material fact with respect to whether HKF acted recklessly. We must reverse the grant of summary judgment and remand for reexamination in light of *Nelson v. Serwold.*

*Duty to Disclose*

Beyond the issue of whether or not appellees were "reckless" is the question of whether they had any duty to disclose material information to appellants. In *White v. Abrams,* 495 F.2d 724, 735-6 (9th Cir. 1974), this court delimited the duty owed by a given plaintiff to a given defendant. Our recent decision in *Zweig v. Hearst Corp.,* 594 F.2d 1261 (9th Cir. 1979), restated the *White* "flexible duty standard":

> [these] factors are relevant in determining the scope of the duty to disclose material facts under Rule 10b-5: (1) the relationship of defendant to plaintiff; (2) defendant's access to the informa-

> tion as compared to that of plaintiff; (3) defendant's benefit derived from the relationship; (4) defendant's awareness of whether plaintiff was relying on their relationship in making his or her investment decisions; and (5) defendant's activity in initiating the transaction in question.

*Id.* at 1268.

A brief application of the present facts to this standard reveals that there was at least a triable issue of fact as to whether appellees owed appellants any duty.

1. *Relationship of Plaintiff to Defendant.*

While the relationship was indirect, it surely existed. HKF knew that a buyer had been found for what was essentially worthless stock. It also knew that without a buyer for its stock, Marconsult would not be in a position to pay HKF's fee. HKF's strong incentive to make Marconsult "look good" on paper created a relationship with any potential buyer not unlike the relationship in *Zweig,* where a financial columnist had a strong incentive to make a particular merger appear attractive to his readers. We there held that the columnist owed a duty to disclose to his readers his interest in the merger.

2. *Defendant's Access to Information.*

It goes without saying that an accountant has greater access to a company's financial data than a potential purchaser. Appellees note that the limited partners could have obtained any needed information by utilizing the subpoena power of the Commissioner of Corporations. Even if they had done so, however, they would not have obtained the data as easily as could HKF, nor would they be as skilled in interpreting the raw data.



3. *Benefit to Defendant.*

As noted above, in light of Marconsult's bleak financial picture, it seems clear that HKF's fees might not have been paid had a buyer not been found.

4. *Defendant's Awareness of Plaintiff's Reliance.*

In initially approving the exchange, the Commissioner severely restricted the transferability of the stock. After he read the 16-month financial statement prepared by HKF, he removed the restriction. This gave rise to a triable issue of fact as to the impact of the financial statement both on the Commissioner and on appellants. As noted earlier, the entire transaction was conditioned on the Commissioner's approval, as HKF well knew. If appellants relied on HKF's statement, it is logical to conclude that appellants relied on HKF, and that HKF knew of this reliance.

5. *Defendant's Initiation of the Transaction.*

This factor is clearly not relevant here, as HKF was consulted only after the transaction was under way. Nevertheless, enough of the factors comprising the "flexible duty standard" are present to conclude that there is a triable issue of fact as to whether or not HKF owed a duty to appellants. Summary judgment was therefore inappropriate.

## CLASS CERTIFICATION

Appellants also protest the district court's denial of class certification.

Rule 23(a) of the Federal Rules of Civil Procedure sets forth these prerequisites to a class action:

> (1) the class must be so numerous that joinder of all members is impracticable,

(2) there must be questions of law or fact common to the class,

(3) the claims or defenses of the representative parties must be typical of the claims or defenses of the class, and

(4) the representative parties must fairly and adequately protect the interests of the class.

The determination whether a class should be certified should not be overturned on review unless it is shown that the district court abused its discretion. *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir. 1976).

Appellants have asserted that joinder of the limited partners is impracticable. Following denial of class status, however, Spectrum was able to reach all 92 limited partners, 56 of whom joined in the second lawsuit that was later consolidated with the original action. This indicates that joinder was not impracticable. Moreover, it may indicate that several potential members of the class did not wish to pursue their claims, despite the fact that it would cost them nothing.

Appellants also contend that all questions of law or fact in the case are common to the limited partners. There is evidence in the pleadings that the several intervenors relied on different communications when they decided to approve the exchange. Some of the representations made to them were by Spectrum, and there may have been reason for the trial judge to believe that the interests of these parties would be in conflict if the case went to trial. Although it appears that most of the issues are common to all potential



members of the class, the judge did not abuse his discretion in denying certification.[1]

We affirm in part, reverse in part, and remand the case to the district court for proceedings in accordance herewith.

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[1]HKF claims that because all 92 of Spectrum's limited partners received notice of the second lawsuit, and because 56 of them elected to join it, the class action question is moot now that the two cases have been consolidated. Thirty-six potential members of the class are not parties to the lawsuit. The issue is not moot unless all potential members of the class are parties.

Spectrum Financial Companies v. Marconsult, 'etc. Nos. 76-2546/2651.

Filed: Nov. 14, 1979.

FERGUSON, District Judge, concurring specially.

While I concur in the decision of the majority, I do not join in that section of the opinion which addresses the issue of duty to disclose. This case provides the circuit with an opportunity to clarify its position on the effect that *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), and *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978), had on our 1974 decision in *White v. Abrams,* 495 F.2d 72 (9th Cir. 1974).

In the three years since the Supreme Court decided *Hochfelder,* overruling the "flexible duty" negligence standard of *White v. Abrams* in favor of a form of scienter involving more than negligence, this circuit has addressed the question of *White v. Abrams*' continuing vitality several times—with varying results.

Initially, this circuit seemed to take the position that the Supreme Court had dealt a death blow to *White v. Abrams* in footnote 12 of *Hochfelder,* where the Court listed the decision as an example of the negligence standard it was repudiating. In *Robinson v. Heilman,* this court held that the scienter standard encompassed some of the factors from the duty analysis, but that there should not be a separate duty inquiry. *Robinson v. Heilman,* 562 F.2d 1304 (9th Cir. 1977). The court stated: "Of course, the closer the relationship of the person charged on the corporation and the greater his participation in the transactions attacked, the easier it will be to prove the requisite *scienter.* That state of affairs, however, provides no justification for any inference that direct participants have any



greater or different duty to buyers or sellers of securities than those whose connections with the transactions may be more remote." *Id.* at 1308.

Then, the circuit resurrected *White* in *Crocker Citizens National Bank v. Control Metals Corp.,* 566 F.2d 631 (9th Cir. 1977). The court held that "[a]bsent the possibility of liability based upon negligence, *Hochfelder* is not inconsistent, on its facts, with the flexible duty standard established in *White v. Abrams.*" *Id.* at 636 n. 2. The circuit reiterated the *Crocker* view in *Zweig v. Hearst,* 594 F.2d 1261, 1268 n. 13 (9th Cir. 1979), and again in *Kidwell ex rel. Penfold v. Meikle,* 597 F.2d 1273, 1294 (9th Cir. 1979); yet it took a different approach in *Ritzau v. Warm Springs West* and treated the standard as "rejected":

> The district court's reliance on the "flexible duty" standard of *White v. Abrams* was well placed at the time of decision, but the Supreme Court has since explicitly rejected that standard in *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 193, n. 12, 96 S. Ct. 1375, a rejection binding on us.

*Ritzau v. Warm Springs West,* 589 F.2d 1370, 1374 (9th Cir. 1979). In addition, when the circuit decided that recklessness satisfies Hochfelder's scienter requirements, it made no mention of a separate duty analysis. *Nelson v. Serwold, supra,* 576 F.2d 1332.

Two district courts in the Ninth Circuit have faced the *Hochfelder/White v. Abrams* issue. In the first case, which predated the opinions listed above, the court held that the flexible duty test and the scienter requirements of *Hochfelder* were each prerequisites to 10b-5 liability. *Carr v. New York Stock Exchange,*

414 F. Supp. 1292, 1300 (N.D. Cal. 1976). More recently, a district court observed that "[b]ecause [the] flexible duty standard permitted liability in certain circumstances based upon negligence alone, its precedential value is in question after *Hochfelder.*" *In re Gap Stores Securities Litigation,* 457 F. Supp. 1135, 1140-41 (N.D. Cal. 1978). After comparing *Crocker-Citizens National Bank v. Control Metals Corp., supra,* with *Robinson v. Heilman, supra,* the court concluded: "Until the Ninth Circuit explicitly re-examines *White v. Abrams,* however, it should be followed to the extent it is not directly inconsistent with *Hochfelder.*" *In re Gap Stores Securities Litigation, supra,* at 1141.

I believe that a re-examination of the flexible duty standard in light of *Hochfelder* shows that the time has come to lay *White v. Abrams* to rest. The five-factor duty analysis helps a court evaluate the foreseeability of harm to a plaintiff from the defendant's actions and the level of culpability of the defendant's conduct. These evaluations are relevant, and even necessary, to a finding of liability based on negligence. After *Hochfelder, supra,* and *Nelson v. Serwold, supra,* however, 10b-5 liability requires proof of recklessness, and the duty analysis is no longer appropriate.

This court has not defined recklessness in the context of securities violations,[1] but the Second and Seventh Circuits have described "[r]eckless conduct [as], at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious

[1]In *Nelson v. Serwold, supra,* 576 F.2d at 1337, we held only that "[t]he evidence supports a finding of recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate and cold-blooded.'"



that the defendant must have been aware of it.'"[2] *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 47 (2d Cir. 1978), *quoting Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977).

If this circuit adopts a similar definition of recklessness, the scienter requirements of *Hochfelder* and *Nelson* will be satisfied when a court concludes that a defendant's conduct was highly unreasonable and presented a known or highly obvious danger to the plaintiff. If the circuit should adopt a different definition, the scienter requirements will be satisfied when the test set forth in that definition is met. There is no reason to require the court then to engage in a complex, multi-faceted duty analysis which was designed to test negligence.

It may be useful at this point to consider a bit of the history of *White v. Abrams.* Before *Hochfelder* established that negligence could not be the basis for 10b-5 liability, the circuit courts wrestled for years with different state of mind requirements. When this circuit decided *White v. Abrams,* Professor Bromberg hailed the five-factor flexible duty standard as "an important break from traditional verbalisms, . . . promis[ing] emphasis on more significant aspects of cases." A. Bromberg, 4 Securities Law, Fraud § 8.4(500) (Supp. 1975).

The verbalisms from which *White* departed were those of common law fraud which had dominated 10b-5 law up to that time. The *White* court's departure

[2]The Second Circuit left open the question whether it would find 10b-5 liability when recklessness was determined under the less strict test established in *Stern v. American Bankshares Corp.,* 429 F. Supp. 818, 826 (E.D. Wis. 1977): "plaintiff must allege . . . that the defendants knew or should have known of the facts and circumstances concerning the fraud." *See Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d at 47 n. 16.

was based, in part, on *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 92 S. Ct. 1456 (1972), where the Supreme Court had held that causation was established without proof of reliance, where the defendants had a duty to disclose but nonetheless withheld material facts. *Id.* at 154, 92 S. Ct. 1472. This court saw *Ute* as disregarding common law fraud elements for an analysis of "what kind of a duty rule 10b-5 imposes." *White v. Abrams, supra,* 495 F.2d at 731. The court stated:

> Although the elements of common law fraud were important in defining what factors should be considered, they were neither limits nor barriers to the extent of the defendant's duty under the rule.
>
> The expressions of the court are not only meaningful, but chart the way for a proper analysis of 10b-5 liability. It is not based upon easily defined, well-known legal theories such as common law fraud, nor is it based upon convenient, differently interpreted, short hand latin phrases behind which one can sweep complex determinations. Rather, we are to examine the totality of the factual context and measure it by the duty imposed on the defendant.

*Id.* at 731-32.

Unfortunately, the duty standard in application sometimes does mask complex determinations. The five factors that the *White* court set out for consideration are:

> [1] the relationship of the defendant to the plaintiff, [2] the defendant's access to the information as compared to the plaintiff's access, [3] the benefit that the defendant derives from the relationship, [4] the defendant's awareness of whether the plaintiff was relying upon their relationship



> in making his investment decisions and [5] the defendant's activity in initiating the securities transaction in question.

*Id.* at 735-36 (footnotes omitted).

Not all factors are necessary to a finding of liability in a given case. *See, e.g., Kidwell ex rel. Penfold v. Meikle, supra,* 597 F.2d at 1296-97; *Zweig v. Hearst, supra,* 594 F.2d at 1269. Instead, a court applying the test must "[w]eigh[] all these facts in light of the principles of full disclosure that Rule 10b-5 was meant to foster." *Kidwell ex. rel. Penfold v. Meikle, supra,* 597 F.2d at 1297.

A court examining elements such as the relationship of defendant to plaintiff and plaintiff's and defendant's relative access to information must weigh many of the same elements that figure into the traditional concepts of materiality and causation.[3] For example, whether a statement could reasonably be expected to influence the decision to sell and was therefore material will be affected by the two factors just listed as well as by defendant's awareness of plaintiff's reliance. Factors (3) and (5), which go to the defendant's culpability, may not be subsumed as clearly within the common law standards, but the two considerations may figure somewhat in the scienter analysis. To the extent that they are not thus incorporated, the factors only serve to confuse the liability determination. There is nothing

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[3]These concepts remain central to 10b-5 liability determinations. The Supreme Court framed the duty approach in *Ute* in terms of materiality and causation, *Affiliated Ute Citizens v. United States, supra,* 406 U.S. at 154; and the lower courts continue to require these elements. *See, e.g., Zweig v. Hearst Corp.,* 594 F.2d 1261, 1266 (9th Cir. 1979); *Nelson v. Serwold, supra,* 576 F.2d at 1335; *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 562 F.2d 1040, 1048 (8th Cir. 1977); *Valente v. Pepsico, Inc.,* 454 F. Supp. 1228, 1236 (D. Del. 1978).

in *Hochfelder* to suggest that a defendant who intentionally causes another to suffer damages through the purchase or sale of a security should be exonerated because he does not benefit financially from the relationship.

Application of the factors sometimes produces awkward results in other ways, as well. This case demonstrates the problem. Factor one looks to the relationship between defendant and plaintiff, properly contemplating a greater likelihood of liability where plaintiff and defendant are in a fiduciary relationship. *See Rolf v. Blyth, Eastman Dillon & Co., Inc., supra,* 570 F.2d at 44. There is no real relationship between plaintiff and defendant here, and there seldom would be one unless defendant were the buyer, seller or broker. Thus the court is confronted with the necessity of manufacturing the relationship from a tenuously defined benefit that the defendant receives from the transaction, as here, or dropping the requirement altogether, as it did in *Zweig v. Hearst Corp.,* 594 F.2d 1261, 1267 (9th Cir. 1979).

We may avoid this problem quite easily by recognizing that the flexible duty negligence standard is just that—a negligence standard. We have followed the Supreme Court's dictates in *Hochfelder* and required scienter instead of negligence. We should recognize that it is, therefore, no longer appropriate to apply a duty standard that was designed to compartmentalize and simplify a negligence inquiry. As does the case before us, *Hochfelder* addressed the liability of an accounting firm for omissions made in connection with the sale of a security. The Supreme Court inquired into scienter and made no separate duty inquiry, and we should do the same.

/s/ Warren J. Ferguson
WARREN J. FERGUSON
United States District Judge



**APPENDIX B.**

MARCONSULT, INC.

**Financial Statements.**

FOR THE PERIOD SEPTEMBER 1, 1970 TO DECEMBER 31, 1971

HARRIS, KERR, FORSTER & COMPANY

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NOTES TO FINANCIAL STATEMENTS

HARRIS, KERR, FORSTER & COMPANY
Certified Public Accountants
727 West Seventh Street,
Los Angeles, California 90017
(Letterhead)

The Board of Directors and Stockholders of
Marconsult, Inc.

We have examined the balance sheet of Marconsult, Inc. at December 31, 1971 and the related statements of common stock and paid-in capital, loss and accumulated deficit, and changes in financial position for the period September 1, 1970 to December 31, 1971. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Certain investments of the Company and the capitalized development costs, which are further discussed in Notes 2 and 3, represent a significant portion of the total assets of the Company at December 31, 1971. Recovery of the investments and development costs is dependent upon the success of the Company, in obtaining future, as well as profitable, projects in these areas.

In our opinion, subject to the recovery of these costs as described in the preceding paragraph, such financial statements present fairly the financial position of Marconsult, Inc. at December 31, 1971 and the results of their operations for the period then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (Note 1).

/s/ Harris, Kerr, Forster & Company
Los Angeles, California
April 24, 1972

MARCONSULT, INC.
BALANCE SHEET
DECEMBER 31, 1971

EXHIBIT A

| ASSETS | | |
|---|---|---|
| CURRENT ASSETS | | |
| Cash | | $ 5,134 |
| Accounts Receivable (Net of Allowance for Doubtful Accounts of $!5,483) | | 33,162 |
| Prepaid Expenses | | 6,399 |
| Total Current Assets | | 44,695 |
| INVESTMENTS (At Cost) (Note 2) | | 42,556 |
| DEVELOPMENT COSTS (Net of Amortization of 13,764) (Note 3) | | 100,318 |
| PROPERTY AND EQUIPMENT (At Cost) (Note 4) | | |
| Marine Equipment | $100,503 | |
| Office Furniture and Equipment | 17,047 | |
| Lab Equipment | 9,787 | |
| Leasehold Improvements | 3,499 | |
| | 130,836 | |
| Less: Accumulated Depreciation | 36,014 | 94,822 |
| OTHER ASSETS | | 1,159 |
| TOTAL ASSETS | | $283,550 |

| LIABILITIES AND STOCKHOLDERS' (DEFICIT) | | |
|---|---|---|
| CURRENT LIABILITIES | | |
| Notes Payable—Bank | | $ 20,000 |
| Notes and Contracts Payable—Other | | 63,817 |
| Accounts Payable | | 112,900 |
| Payroll Taxes Payable | | 21,683 |
| Accrued Expenses | | |
| Salaries | | 8,952 |
| Interest | | 4,306 |
| Advance Deposit on Contract | | 25,000 |
| Total Current Liabilities | | 256,658 |
| ADVANCES AND NOTES PAYABLE — OFFICERS (Note 5) | | 40,715 |
| STOCKHOLDERS' (DEFICIT) | | |
| Common Stock $.10 Par Value 2,000,000 Shares Authorized 724,554 Shares Issued and Outstanding (Exhibit B) (Note 6) | $ 72,455 | |
| Paid-in Capital (Exhibit B) | 260,119 | |
| Accumulated (Deficit) (Exhibit C) (Note 1) | (346,397) | |
| Total Stockholders' (Deficit) | | (13,823) |
| TOTAL LIABILITIES AND STOCKHOLDERS' (DEFICIT) | | $283,550 |

See accompanying Notes to Financial Statements.

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EXHIBIT B

MARCONSULT, INC.

STATEMENT OF COMMON STOCK AND PAID-IN CAPITAL

DECEMBER 31, 1971

| | Common Stock | Paid-In Capital |
|---|---|---|
| BALANCE—September 1, 1970 | $65,000 | $ 65,000 |
| March 31, 1971—Exercise of Stock Options for 6,500 Shares at $1.92 (Note 6) | 650 | 11,850 |
| June 30, 1971—Purchase and Retirement of 19,000 Shares in Exchange for 19,000 Shares of International Oil and Gas, Ltd., Valued at $3,867 (Note 2) | (1,900) | (1,967) |
| June 30, 1971—Cancellation of Contingent Stock Options for 69,149 Shares in Exchange for 20,000 Shares of International Oil and Gas, Ltd., Valued at $4,069 (Note 2) | | (4,069) |
| October 31, 1971—Net Proceeds from Public Sale of 87,054 Shares of Common Stock | 8,705 | 189,305 |
| BALANCE—DECEMBER 31, 1971 | $72,455 | $260,119 |

See accompanying Notes to Financial Statements.

EXHIBIT C

MARCONSULT, INC.

STATEMENT OF LOSS AND ACCUMULATED (DEFICIT)
FOR THE PERIOD SEPTEMBER 1, 1970 TO
DECEMBER 31, 1971

| | |
|---|---|
| **INCOME** | |
| Consulting Fees | $ 351,402 |
| Other | 471 |
| Total Income | 351,873 |
| **EXPENSES** | |
| Specific Job Costs | 175,051 |
| Salaries | 317,849 |
| Rent | 14,500 |
| Interest | 15,886 |
| Depreciation and Amortization (Note 4) | 28,446 |
| Amortization—Development Costs (Note 3) | 13,764 |
| Other Expenses | 104,390 |
| Total | 669,886 |
| Less: Capitalized Development Costs (Note 3) | 120,342 |
| Total Expenses | 549,544 |
| NET LOSS BEFORE EXTRAORDINARY ITEM | (197,671) |
| Loss on Investment (Note 8) | 25,000 |
| Abandoned Projects (Note 8) | 50,273 |
| Total Extraordinary Items | 75,273 |
| NET LOSS | (272,944) |
| ACCUMULATED (DEFICIT) — Beginning of Period (Note 1) | ( 73,453) |
| ACCUMULATED (DEFICIT) — End of Period (Exhibit B) | $(346,397) |
| Loss Per Common Share (Note 7) | |
| Net Loss Before Extraordinary Item | $ (.29) |
| Extraordinary Item | (.12) |
| Net Loss | $ (.41) |

See accompanying Notes to Financial Statements.



EXHIBIT D

MARCONSULT, INC.

STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE PERIOD SEPTEMBER 1, 1970 TO
DECEMBER 31, 1971

| | |
|---|---|
| **FUNDS PROVIDED** | |
| Proceeds from Sale of Equipment | $ 15,510 |
| Proceeds from Officers Loans | 18,500 |
| Proceeds from Sale of Common Stock | 198,009 |
| Conversion of Notes Payable for Common Stock (Note 6) | 12,500 |
| Total Funds Provided | 244,519 |
| **FUNDS APPLIED** | |
| Operations | |
| Net Loss for the Year Before Extraordinary Item | (197,671) |
| Expenses not Requiring Cash Outlay | |
| Depreciation | 28,446 |
| Amortization | 13,764 |
| Officers Salaries | 23,958 |
| Other | 5,606 |
| Capitalized Costs (Note 3) | (120,342) |
| Funds Applied to Operations | 246,239 |
| Purchase of Property and Equipment | 72,695 |
| Decrease in Long-Term Debt | 24,183 |
| Payments on Officers Loans | 12,724 |
| Other | 170 |
| Total Funds Applied | 356,011 |
| DECREASE IN WORKING CAPITAL | $(111,492) |
| **CHANGES IN WORKING CAPITAL** | |
| Increase (Decrease) in Current Assets | |
| Cash | $ (13,867) |
| Accounts Receivable | (145,950) |
| Prepaid Expenses | (5,020) |
| (Increase) Decrease in Current Liabilities | |
| Notes and Contracts Payable | 34,761 |
| Accounts Payable | 45,245 |
| Payroll Taxes and Accrued Expenses | (4,161) |
| Advance Deposit on Contract | (22,500) |
| DECREASE IN WORKING CAPITAL | $(111,492) |

See accompanying Notes to Financial Statements.

MARCONSULT, INC.

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1971

NOTE 1—CHANGE IN ACCOUNTING PERIOD

The Company elected to change its reporting period from an August 31 to December 31 year end. Accordingly, the statement of income and accumulated deficit reflects the operations from September 1, 1970 to December 31, 1971. The gross revenue and net loss for the four months ended December 31, 1970 amounted to $294,529 and $(27,340) respectively.

NOTE 2—INVESTMENTS

Investments consist of the following:

| | Cost |
|---|---|
| 50,176,714 shares of Fortuna Offshore Mining & Exploration Corporation under a subscription agreement. Fortuna is engaged in both onshore and offshore mineral and oil resource development activities.<br>This is a Philippine corporation with 8,120,000 shares of stock issued and outstanding, and 1,290,536,712 shares under subscription obligations at December 31, 1970; the shares owned by the Company are included in the total shares under subscription.<br>The stock is presently traded in the over-the-counter markets in the Philippines at approximately 0.013 Pesos per share or a total value of about $100,354. However, the Company has been informed that trading in the stock is on a very limited basis and there is no assurance that the Company could readily convert its entire investment into U.S. dollars during any short period of time. In addition, if the Company chose to liquidate its investment it would first have to retire its subscription obligation totalling 376,325 Pesos which has a U.S. dollar equivalent value at this date of approximately $59,000. | $32,165 |
| 51,000 shares of preferred stock of International Oil and Gas, Ltd.<br>On June 17, 1971, the Corporation exchanged its investment in 490 shares of Greenland Exploration Management Company (GEMCO) Incorporated for 90,000 shares of preferred stock of International Oil and Gas, Ltd. (a Tennessee Corporation) and a $50,000 note, due February 1, 1972, or sooner, upon certain events. | $10,391 |



The stock has been valued at the same cost basis as the shares of GEMCO which were exchanged. The Company has granted a six month extension on the maturity of the note receivable. The Company has not reflected the note receivable in its financial statements because of the uncertainty of collection which is contingent upon the sale of stock for cash by International Oil and Gas, Ltd. of not less than $1,000,000.

The note receivable is secured by an agreement to convey to the Company up to a maximum of 20% of International's interest in GEMCO, subject, however, to the obligation of International to first offer said interest to the other party to the GEMCO joint venture at a price equal to the unpaid indebtedness.

Concurrently with the exchange of shares of GEMCO, the Company entered into a series of agreements wherein 39,000 shares of International that the Company received were transferred to Mr. Gustavson (former president of Marconsult, Inc.) in exchange for the cancellation of his contingent option to acquire 69,149 shares of common stock and the surrender for cancellation of 19,000 shares of common stock of the Company then owned by Mr. Gustavson. The cost of reacquiring the shares and stock option was based on a proration of the original cost of the GEMCO shares as explained previously. The costs relating to these transactions have been charged against common stock and paid-in capital.

NOTE 3—DEVELOPMENT COSTS

The Company has adopted the policy to defer costs relating to projects in the developmental or proposal stage. In addition the Company has deferred certain costs over and above those funded on previous projects. The Company anticipates future sales and profits will be derived from its investments in the projects.

For the four months ended December 31, 1970, the Company deferred costs of approximately $11,500 relating to the projects under development and charged to operations during the same period approximately $50,000 of previously deferred project costs. During the year ended December 31, 1971, the Company deferred costs of approximately $77,900 relating to the same projects.

The Company also established the policy of amortizing these costs over an estimated life of generally 5 to 7 years. Such

NOTE 3—DEVELOPMENT COSTS—Continued

costs amortized for the year ended December 31, 1971 and the four months ended December 31, 1970 amounted to $12,167 and $1,597 respectively.

The Company also develops, builds and/or modifies certain equipment which it considers necessary for its operations. Costs capitalized for the year ended December 31, 1971 amounted to approximately $22,000; costs capitalized in prior periods amounted to approximately $9,000.

NOTE 4—PROPERTY AND EQUIPMENT

Depreciation has been computed on a straight-line basis for both accounting and tax reporting at annual rates averaging 33-1/3 percent for Marine Equipment, 10 percent to 20 percent for Laboratory Equipment, 12-1/2 to 33 percent for Office Furniture and Equipment and 20 percent for Leasehold Improvements.

NOTE 5—ADVANCES AND NOTES PAYABLE—OFFICERS

The advances and notes payable consists of advances of approximately $35,000 for accrued salaries and $5,700 of non-interest bearing loans at December 31, 1971.

NOTE 6—STOCK OPTIONS AND WARRANTS

In September, 1970, the Board of Directors authorized a Qualified Stock Option Plan, approved by the shareholders in November, 1970, whereby 80,000 shares of the Company's common stock were reserved for issuance to key employees of the Company.

Certain key employees held options under the Company's qualified stock option plan to purchase an aggregate of 14,300 shares of common stock at December 31, 1971. The option prices range from $.48 to $3.00 per share and expire five years after date of grant in 1975 and 1976.

An option to purchase not to exceed 52,700 shares of common stock at $.20 per share exercisable on or before February 14, 1975, remains outstanding to a note holder who advanced monies to the Company in 1968.

At the time of the initial public sale of the Company's common stock in October, 1971, the Company sold warrants to its securities marketing company; the warrants consist of the right to purchase 8,000 shares of common stock at exercises prices ranging from $3.00 to $3.63 per share and expires in October 1976.

During the year ended December 31, 1971, options for 6,500 shares were exercised in exchange for payments of Notes Payable totaling $12,500. In addition, options to purchase shares totaling 5,850 and 69,149 shares (see Note 2) were either cancelled and/or repurchased respectively.



NOTE 7—LOSS PER SHARE

Loss per common share for the period has been computed based on the actual shares outstanding for the four months ended December 31, 1970 and on the weighted average of shares outstanding during the year ended December 31, 1971 which totaled 659,879. Options and warrants have not been recognized in their computations as the affect in loss per share would have been anti-dilutive.

NOTE 8—EXTRAORDINARY ITEM

In 1971, the Company determined that the investment in Offshore Minerals Corporation, Inc. had no value and as a result has provided for the loss of investment of $27,000 less a liability due to the Company by Marconsult, Inc. of $2,000.

In 1970, the Company ceased work in certain developmental projects and has expensed such costs totalling $50,373 as abandoned projects.

NOTE 9—INCOME TAXES

The Company has available net operating loss carryforwards totalling approximately $103,000 which expire from 1973 to 1976.

NOTE 10—SUBSEQUENT EVENTS

Effective January 1, 1972, the Company entered into an agreement to acquire the outstanding stock of Cannon Diamond Drilling Company, Ltd. in exchange for 40,000 shares of common stock of Marconsult, Inc. for an assigned value of $320,000. The unaudited book value of the company at January 1, 1972 approximates $325,000.

Also effective January 1, 1972, the company entered into an agreement to purchase certain assets (consisting of 16 gas and one oil well) of an oil and gas limited partnership venture in exchange for 145,000 shares of common stock of Marconsult, Inc. for an assigned value of $550,000, plus a convertible note payable in the amount of $250,000. In addition, the company assumed a mortgage liability of approximately $193,000. The agreement has not been finalized as the company requested a hearing before the California Commissioner of Corporations which is presently pending.